

K. IRC 7428: DECLARATORY JUDGMENT RECENT DEVELOPMENTS

1. Introduction

Subsequent to enactment of the declaratory judgment provisions of IRC 7428, a number of controversies have arisen. Issues under IRC 7428 tend to fall within one of three areas: (1) what technical issues are subject to declaratory judgment; (2) which actions give rise to declaratory judgment rights; and, (3) the time at which an organization can institute court action. The principal purpose of this discussion is to consider the impact that court cases have had on IRC 7428 cases.

2. Technical Issues Subject to IRC 7428 Relief

IRC 7428 grants declaratory judgment rights to organizations on four issues: (1) exempt status under IRC 501(c)(3); (2) qualification as an organization to which contributions are deductible by reason of being described in IRC 170(c)(2); (3) IRC 509 foundation classification; and, (4) IRC 4942(j)(3) private operating foundation status. IRC 509 foundation classification is the sole area where a controversy has arisen. It is evident that IRC 7428 grants declaratory judgment rights to an organization that is a private foundation. The Service initially administered the IRC 7428 provisions on the basis that no declaratory judgment rights existed on foundation classification so long as the organization was not classified to be a private foundation. This approach was initially acceptable to the courts. See Ohio County and Independent Agriculture Societies, Delaware County Fair v. Commissioner (6th Cir.) 610 F. 2d 448 (1979), affirming an unreported Tax Court Case. However, the Tax Court thought otherwise in Friends of the Society of Servants of God v. Commissioner, 75 T.C. 209 (1980). The key element triggering the difference in result apparently was produced by the difference in reasons given for seeking a preferred foundation classification. In Ohio, the organization baldly stated that it was seeking a benefit under IRC 511-514 in asking for IRC 170(b)(1)(A)(v) status. In Friends, the organization persuasively argued that it only marginally qualified under IRC 170(b)(1)(A)(vi) and thus should be able to contest an adverse 170(b)(1)(A)(i) ruling. Friends can be argued to stand for the proposition that declaratory judgment rights should only exist where a final foundation status is sought and only an advance ruling is given. However, the decision seems to go further than that. Furthermore, the appellate court decision, Create, Inc. v. Commissioner, 634 F. 2d 803 (1981), clearly states otherwise.

Although declaratory judgment rights were for other reasons found not to be present, the Create opinion clearly states that declaratory judgment rights exist where a favorable, definitive public charity status has been given but it is not the public charity status that the organization prefers.

While the Service has not published A definitive position with respect to the decision on Friends and the discussion in Create, it appears likely that it will publish a position that declaratory judgment rights exist if an organization expresses a strong preference for a particular public charity classification. Amendment of IRM 7662 is anticipated. The only change would relate to processing the case subsequent to granting protest and conference rights. IRM 7662(b) at present grants protest and conference rights to organizations expressing a strong preference for a particular public charity foundation classification. It is anticipated that IRM 7662(c) will be amended to state that declaratory judgment rights exist. Equivalent amendments to Rev. Proc. 80-25, 1980-1 C.B. 667, are expected.

Outright rejection of Friends and Create would probably only occur if a general recognition developed that an unanticipated administrative burden had been produced. An intermediate position is possible. It is conceivable that the Service could grant declaratory judgment rights only where church status is preferred or, alternately, where an advance ruling is given but the organization prefers a definitive ruling. It seems evident that the Service cannot make a determination of this type on a case by case basis, i.e., the Service cannot analyze the organization's motives in each case to determine whether or not the organization has a proper reason for pursuing a particular foundation classification.

3. Actions Giving Rise To IRC 7428 Rights

Two broad categories of IRS actions on declaratory judgment issues give rise to declaratory judgment rights. IRC 7428 grants declaratory judgment rights to organizations with respect to their initial or continuing status. Thus, adverse actions on declaratory judgment issues in response to an application for recognition of exemption on Form 1023 give rise to declaratory judgment rights. Also, revocation or modification of an organization's status gives rise to declaratory judgment rights if an appropriate issue is involved. While normally this would consist of revocation or modification of a previously issued ruling or determination letter, IRC 7428 declaratory judgment rights arise as a result of modification or revocation of an organization holding itself out in good faith to be a church. Because churches are not required to comply with IRC 508(a), it is not uncommon

for organizations that consider themselves to be churches to consider themselves to be exempt churches without applying for such status. In the event that the Service contests such a claim, the organization would have declaratory judgment rights.

Ruling or determination letters on specific transactions do not give rise to declaratory judgment rights unless they cause a loss of status involving a declaratory judgment issue. An adverse ruling that a particular receipt of an organization is not a contribution for purposes of IRC 170 does not give rise to declaratory judgment rights unless it causes loss of a particular IRC 509 status; an adverse ruling that an activity did not further IRC 501(c)(3) purposes would not give rise to declaratory judgment rights unless it caused loss of IRC 501(c)(3) status. See Create, Inc., supra.

4. Time When Court Action Begins

Until recently, it seemed quite clear what constituted a final adverse letter and what was subject to the 270 day provisions of IRC 7428(b)(2). However, this changed with the decision in J. David Gladstone Foundation v. Commissioner, 77 T.C. No. 19 (1981). Although the Gladstone decision involved a type of case that has become extinct, the decision cannot be dismissed as an academic fossil. Even though the Service no longer has the National Office appeals procedure used in Gladstone, the court's reasoning has application to other situations where status is revoked or modified, particularly if technical advice is sought. For purposes of analysis, Gladstone has two significant aspects: first, the means by which the technical decision was announced to the organization: and second, the question of what actions constitute an application for a determination within the meaning of IRC 7428(b).

The Tax Court could have based its decision on a finding that the organization had already received its final adverse letter. In Gladstone, the National Office appeals decision was mailed directly to the organization. The Tax Court could have concluded that the final adverse action had been taken with the National Office decision and that any further correspondence was superfluous. However, it did not do so. As a result, it is not clear whether the delay in issuing the final adverse letter after the appeals decision, apparently caused in part by the organization's request for reconsideration, had any impact on the court. The appeals letter to the organization was dated January 23, 1980; the final adverse letter was dated May 28, 1980.

Currently, technical advice cases are handled somewhat differently. Technical advice memoranda are issued to the requesting field office without any direct written contact with the subject organization; the subject organization receives its copy from the requesting field office. At present, there is no set procedure for giving an organization its copy. There is no requirement that it be given to the organization contemporaneously with issuance of a final adverse letter. However, if both acts are simultaneous, it reduces the likelihood of the Gladstone situation reoccurring. In Gladstone, the organization apparently realized that the decision was final and probably filed its petition with the Tax Court in an attempt to shift the burden of proof.

Normally an organization must exhaust its administrative remedies before it can file a petition for declaratory judgment relief. IRC 7428(b)(2) contains an exception for organizations requesting the determination of an issue. Before proceeding further, it is useful to set forth the basic types of declaratory judgment cases that arise. There are two types of cases initiated by organizations. First, an organization can request an initial determination of its status, i.e., it has not previously requested any status. Second, an organization can request a preferred status subsequent to receipt of a determination of its status, which in some cases would be many years subsequent to the initial classification and might well involve changed circumstances. Other declaratory judgment cases result from IRS action; revocation or modification of a ruling or determination letter, or contesting the status of an organization with a bona fide claim to be a church to which IRC 508(a) does not apply.

Organizations that have received a ruling or determination letter retain that status until revocation or modification of that letter. Thus, a proposed revocation or modification does not effect a change of status if protested. A proposed revocation or modification is no longer material in determining when IRC 7805(b) relief is cut off. If the proposed revocation or modification is based on the same facts as the original determination or ruling letter and there has been no change in law, relief under IRC 7805(b) is provided through the date of the final letter revoking or modifying status. See section 13 of Rev. Proc. 80-25, 1980-1 C.B. 667.

IRC 7428(b)(2) permits organizations to bring a declaratory judgment action if 270 days have elapsed since the organization applied for a determination and the organization acted in a timely manner in pursuing an application for a determination. In Gladstone, the Tax Court determined that the provisions of IRC 7428(b)(2) applied to a proposed revocation of a ruling or determination letter conferring a preferred status. This interpretation is difficult to reconcile with the

statutory language as well as its intent. First, no natural construction of this phrase would cause it to include proposed revocations or modifications. Furthermore, while IRC 7428(a) refers to "revocation or other change in qualification or classification" no such reference is contained in IRC 7428(b)(2). The basic purpose in enacting IRC 7428, and IRC 7428(b)(2) in particular, was to permit organizations not having a preferred status to obtain a prompt determination of their status and to provide quick recourse through the courts. The decision in Gladstone is not consistent with this. Unless revoked or modified, an organization holding a ruling or determination letter with a preferred classification continues to hold that status. Thus, proposed modification or revocation involves no immediate detriment. The Gladstone decision also cannot be reconciled with interpretation of IRC 7428(b)(2) by the District Court of the District of Columbia. See New York County Health Services Review, Inc. v. Commissioner, 80-1 USTC 9398 (1980).

It is too early to determine whether the Gladstone decision on IRC 7428(b)(2) will stand; the Service may appeal the decision and prevail. However, this does not mean that the decision should be completely disregarded. Two things should be borne in mind in processing revocation or modification cases. Because the 270 day period under Gladstone does not start to run until there is a protest of a proposed modification or revocation, full development in an examination case prior to proposing revocation or modification should help avoid accusations that there has been an unreasonable delay. (Note that in Christian Stewardship Assistance, Inc. v. Commissioner, 70 TC 1037 (1978), a 588 day period was held not to be unreasonable, demonstrating that expiration of 270 days does not grant an automatic right to file.) Also, eliminating delay in processing the case after a proposal to revoke or modify has a similar effect, particularly after a technical advice memorandum has been issued.